

Dee May
Executive Director
Federal Regulatory



1300 I Street N.W., Floor 400W
Washington, DC 20005

Phone 202 515-2529
Fax 202 336-7922
dolores.a.may@verizon.com

March 30, 2001

Ex Parte

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th St., S.W. – Portals
Washington, DC 20554

RE: Application by Verizon New England Inc., et al., for Authorization To Provide In-Region, InterLATA Services in Massachusetts, Docket No. 01-9

Dear Ms. Salas:

The attached information was provided to in response to follow up with the Legal Advisors. Please let me know if you have any questions. The twenty-page limit does not apply as set forth in DA 01-106.

Sincerely,

A handwritten signature in cursive script that reads "Dee May".

cc: E. Einhorn
K. Farroba
R. Bcynon
S Whitesell
K. Dixon
J. Goldstein
S. Pie

VERIZON'S DISCOUNTS ON NEW SWITCHES

AT&T and WorldCom argue that Verizon's switching rates in Massachusetts, which are at the same levels as the switching rates in New York, are based on misstatements by Verizon regarding its discounts on new switches and, therefore, do not fall within the range that a reasonable application of TELRIC principles would produce. AT&T and WorldCom have been making this exact same argument for nearly three years, and it has been squarely rejected by the New York PSC, this Commission, and the D.C. Circuit.

1. In April 1997, the New York PSC established Verizon's rates for unbundled switching. There were three cost studies before the PSC – one from Verizon, one from AT&T and MCI, and one from the PSC staff. The PSC based Verizon's switching rates on the study submitted by the PSC's staff, which resulted in a rate that was much closer to the AT&T/MCI study than to the Verizon study.
2. In June 1998, AT&T and WorldCom moved to reopen the New York PSC's proceeding that established unbundled switching rates. They claimed that "new evidence" – in particular contracts between Verizon and its two largest switch vendors – revealed that one of the two vendors gave Verizon large discounts on both new and replacement switches, not just on replacement switches as Verizon had previously indicated, and as the New York PSC assumed in establishing Verizon's switching rates.
3. In September 1998, the New York PSC rejected AT&T and WorldCom's motion.
 - *First*, the PSC noted that it based Verizon's switching rates on the analysis of its own staff, not on the study submitted by Verizon.

"Struck by the extremely wide discrepancy between the switching cost figures used by the two studies (New York Telephone's \$586 per line and Hatfield's \$125 per line, both inclusive of installation costs), we regarding that gap as itself calling the figures into question and went on to cite various other factors that led us to reject both estimates. We used, instead, a Staff analysis that was based on a per-line installed cost, derived from historical data, of about \$300. . . . In the Phase I Rehearing Opinion we affirmed our switching cost analysis in the face of challenges by both New York Telephone and MCI. . . . We rejected . . . New York Telephone's critique, including a claim, which we found unproven, that the 5.72% price reduction factor [which reduced the price per line to \$193] was belied by certain Bureau of Labor Statistics data . . ." (at 3-4)

- *Second*, the PSC found that it could not simply make a "selective update" or "simple arithmetic correction" to Verizon's switching rates because any change in the assumption regarding discounts would affect other assumptions "with unpredictable results." (at 8, 10)

“[W]hile the adjustment called for here would not be an update, the rationale for disfavoring selective updates – they fail to recognize that other updates might move in the opposite direction – bears on selective after-the-fact modifications such as this one, as well. . . . Once switching costs were reopened, one might also envision changes to the Staff analysis that would *increase* the calculated switching costs The web of interconnected effects argues strongly against making the selective modification urged by the motion without a comprehensive review of switching costs or, indeed, all element costs.” (at 10-11)

- *Third*, the PSC found that, even if the new evidence regarding Verizon’s switch discounts might result in a downward adjustment in Verizon’s rates, the rates were no less compliant with TELRIC as a result.

“Staff regarding its Phase 1 switching cost result, and we adopted it, not as a mathematically precise calculation of switching costs but as a reasonable forward-looking estimate, building on actual historical data that included both new switches and ‘growth’ additions to existing switches, that could be used to set rates given the wide gulf between the parties’ estimates and in the absence of a persuasive study by any party. *The new information might warrant modifying that estimate in one way, but the prospect of that modification would not negate the overall reasonableness of the rates we set.*” (at 10)

4. In the proceedings before this Commission regarding Verizon’s New York § 271 Application (which took place between September and December 1999), AT&T and WorldCom again claimed that Verizon’s switching rates were not TELRIC compliant because they relied on incorrect assumptions regarding Verizon’s discounts on new switches. In its Evaluation and Reply Comments, the New York PSC again rejected these arguments.

- *First*, the PSC again stated that it based Verizon’s switching rates on the analysis of its own staff, not on the study submitted by Verizon, and that the resulting rates complied with TELRIC.

“More fundamentally, AT&T implicitly mischaracterizes the New York Commission’s treatment of switching costs in Phase 1. The decision was grounded on an analysis undertaken by the NYPSC’s Staff after recognizing the serious flaws in both Bell Atlantic-NY’s study and the Hatfield Model proffered by AT&T and MCI WorldCom. The result of that analysis was adopted “not as a mathematically precise calculation of switching costs” but as a figure, well within the range of reason as established by the TELRIC-based record, that was more reliable than the widely differing results of the parties’ flawed, competing studies.” (PSC Reply at 48)

“Rates for resale, network elements and interconnection (reciprocal compensation) have been set that satisfy the 1996 Act and the FCC’s avoided cost and TELRIC rules thereunder.” (PSC Eval. at 152) “In setting prices, the

NYPSC has applied a forward-looking TELRIC method consistent with that prescribed in the FCC's pricing rules." (PSC Eval. at 156) "[W]e can advise the FCC that prices conforming to the FCC's requirements are in effect for resale, interconnection, and unbundled network elements provided by Bell Atlantic-NY." (PSC Eval. at 162).

- *Second*, the PSC again stated that it could not simply modify a single input in isolation, and that doing so likely would require offsetting changes in other inputs.

"AT&T's criticisms appear misdirected in two respects. First, as the NYPSC itself observed, the decision reflects a complex analysis that does not lend itself to simple arithmetic correction through adjustment of a single input." (PSC Reply at 48)

- *Third*, the PSC again stated, even if the new evidence regarding Verizon's switch discounts might result in a downward adjustment in Verizon's rates, the rates were no less compliant with TELRIC as a result.

"Thus, AT&T's criticisms appear misdirected in two respects. . . . Second, *the switching rates now in effect should not be seen as mere "placeholders."* They embody a reasonable calculation of pertinent costs, arrived at by the NYPSC Staff's application of forward-looking TELRIC analysis. The evidence cited by AT&T may imply need to refine those rates in one direction; but, contrary to AT&T's suggestion, not only the magnitude but even the direction of the overall body of refinements that may prove warranted cannot now be foreseen. *The rates remain temporary pending those refinements, but they are no less TELRIC-compliant on that account.*" (PSC Reply at 48)

5. In December 1999, the FCC explicitly rejected AT&T's and WorldCom's claims, affirmed each of the three grounds on which the New York PSC reached the same conclusion, and granted Verizon's application.

- *First*, the Commission affirmed that the PSC had relied on its own cost study, rather than the studies proposed by Verizon or AT&T/MCI and that the resulting rates comply with TELRIC.

"We reject AT&T's allegation that Bell Atlantic's switching prices violate TELRIC principles because they fail to account for any cost savings from the steep switch discounts that an efficient carrier operating in the long run would unquestionably receive. AT&T previously raised this issue with the New York Commission, which considered AT&T's assertion and made significant modifications to Bell Atlantic's proposed switch prices. Using its TELRIC-based model, Bell Atlantic calculated an average total installed switch investment of \$586 per line. This switch cost was significantly higher than those calculated by AT&T under the Hatfield model, which calculated a per-line switch investment of \$125. The New York Commission held that the wide disparity between the two

TELRIC models' inputs called both figures into question, and that the record before it suggested that neither figure was reliable. The New York Commission then conducted its own examination into switching costs, after which it estimated a per-line switch cost of \$303, which it reduced to \$192 to account for declining switch prices within the industry. The New York Commission contends that the resultant switch prices are TELRIC-based. Based on the evidence in the record, we find that the New York Commission has already considered AT&T's allegation that Bell Atlantic's proposed switch costs were too high and responded appropriately. Bell Atlantic may only recover \$192 per switch per line, a significant reduction from its original proposal of \$586 per line and an amount much closer to AT&T's estimation. We have no basis to disagree with the New York Commission that its calculation of switching costs is a 'reasonable calculation of pertinent costs, arrived at by the New York Commission Staff's application of forward-looking TELRIC analysis.'" (§ 242)

"We find no basis to disagree with the New York Commission's assertion that it calculated pertinent costs 'arrived at by the NYPSC Staff's application of forward-looking TELRIC analysis.' Moreover, we are not persuaded that Bell Atlantic's switching costs are based on speculation, simply because AT&T believes the New York Commission did not adequately reflect switching discounts. As discussed above, the New York Commission engaged in extensive fact-finding in its rate case, and specifically considered AT&T's assertions about switching discounts. As a result, Bell Atlantic's switching prices were greatly reduced, with a final result that is very close to AT&T's estimated switching prices, further undermining AT&T's claims that Bell Atlantic's switch prices are double or even triple what they should be.'" (§ 246)

- *Second*, the Commission affirmed the PSC's finding that it could not simply modify a single input in isolation, and that doing so likely would require offsetting changes in other inputs.

"We also agree with the New York Commission that its determination of allowable switch costs was the result of a complex analysis that does not lend itself to simple arithmetic correction through the adjustment of a single input. AT&T has presented no evidence to persuade us that New York did not conform to TELRIC principles simply because it failed to modify one input into its cost model.'" (§ 245)

- *Third*, the FCC affirmed the PSC's conclusion that, even if the new evidence regarding Verizon's switch discounts might result in a downward adjustment in Verizon's rates, the rates were no less compliant with TELRIC as a result.

"Third, we see no reason to disagree with the New York Commission that Bell Atlantic's switch costs are not 'interim' merely because they may be adjusted in the future to account for newly adduced evidence. The New York Commission held that, while it had initially been persuaded by Bell Atlantic that it did not receive large switch discounts from its vendors, AT&T later presented new

evidence on such discounts, which the New York Commission will examine in its second network elements rate case. *AT&T has presented no evidence that the New York Commission's 'ongoing examination of the [switch discount] issue betokens a failure to set TELRIC-compliant rates,' nor does it refute the New York Commission's claim that these rates may be refined in the future, 'but they are no less TELRIC-compliant on that account.'*" (§ 247)

6. AT&T appealed the FCC's decision, yet again raising the argument about the discounts Verizon receives on new switches. The D.C. Circuit upheld the Commission's decision, affirming each of the three grounds on which the Commission relied.

- *First*, the court acknowledged that the New York PSC had established switching rates based on an analysis performed by its own staff.

"Addressing switching costs in its April 1997 pricing order, the NYPSC began by noting the wide disparity between the estimates provided by Bell Atlantic (\$586 per line) and AT&T (\$125 per line). Based on that disparity, other evidence in the record, and its own analysis, the agency found 'neither figure ... reliable.' 1997 NYPSC Order at 84. 'In these circumstances,' the NYPSC explained, '[its] staff examined the data on switching costs closely.' *Id.* at 85. Starting with the historic cost of switches installed in 1993 and 1994, the agency adjusted that cost downward to reflect the declining price of switches, yielding a per-line price of \$192.67." (220 F. 3d at 617)

- *Second*, the court upheld the FCC's decision to rely on the PSC's finding that it could not simply modify a single input in isolation, and that doing so likely would require offsetting changes in other inputs.

"Moreover, both the NYPSC and the FCC agree that adjusting switching rates to reflect discounts is not so simple as subtracting the amount of the discount; it requires other adjustments to the cost model. Under these circumstances, we are comfortable deferring to the Commission's conclusion that basic TELRIC principles have not been violated and that the NYPSC has not made such 'clear errors in factual findings' that switching costs fall 'outside the range that the reasonable application of TELRIC principles would produce.'" (220 F. 3d at 617)

- *Third*, the court upheld the Commission's reliance on the PSC's conclusion that, even if the new evidence regarding Verizon's switch discounts might result in a downward adjustment in Verizon's rates, the rates were no less compliant with TELRIC as a result.

"The FCC found no problem with the NYPSC's resolution of this issue. 'AT&T has presented no evidence to persuade us that New York did not conform to TELRIC principles simply because it failed to modify one input into its cost model.' Bell Atlantic, 15 F.C.C.R. at 4085 p 245. Sympathetic to the NYPSC's position that 'its determination of allowable switch costs was the result of a complex analysis that does not lend itself to simple arithmetic correction through

the adjustment of a single input,' *the FCC concluded that the prospect of future modification makes the rates no less TELRIC-compliant. Id. The FCC's decision seems reasonable to us.* Not only are state-agency-approved rates always subject to refinement, but we suspect that rates may often need adjustment to reflect newly discovered information, like that about Bell Atlantic's future discounts. If new information automatically required rejection of section 271 applications, we cannot imagine how such applications could ever be approved in this context of rapid regulatory and technological change." (220 F. 3d at 617)